

# Market Outlook

## At-A-Glance

Economists and the Fed have both increased U.S. economic growth expectations for 2024 as economic data has exceeded expectations. The Federal Reserve Bank of Atlanta now estimates first quarter economic growth to be over 2%.

The Fed had been reluctant to cut rates because of the potential for inflation reaccelerating, which we witnessed in January and February. The three- and six-month annualized inflation rates moved back above the Fed's 2% target. The longer-term 12-month inflation rate edged lower but is also above the target.

Consumer spending remains strong as the unemployment rate has been below 4% for 25 consecutive months. A feat not accomplished since the 1960s when the unemployment rate remained below 4% for 27 straight months.

Stock markets have rallied on economic resiliency while discounting recent inflation data. Future earnings projections have been raised but have yet to be realized. This could be setting the stage for some stock market volatility to come. However, it could be short-lived, and could provide opportunities.

## Stocks Spring Forward Overview

As we approach the end of the first quarter of 2024, our thesis for the year is still intact. We believe the Fed will eventually go from a headwind to a tailwind and cut interest rates, however, this may happen later than anticipated. Additionally, the economy remains resilient and the prospects for a near-term recession are low. Finally, with stocks moving higher with little resistance since the end of October, we expect volatility to eventually emerge.

For the Fed to cut rates they will need to see more data confirming inflation is on a path toward their 2% target. January and February data were bumps in the road as inflation ran hotter than expected. The good news is that the Fed is not overreacting to these data points and still believes inflation is trending lower. In the Fed's March Federal Open Market Committee (FOMC) meeting where they discuss interest rates and inflation, the committee kept their year-end interest rate expectations unchanged. The median projection for the Fed Fund's rate remains 0.75% lower by year end. Conceivably, this could mean the Fed cuts rates by 0.25% in June, September, and December.

The recent FOMC meeting also gave credence to our second theme for 2024, that the U.S. could avoid a recession this year. The committee's median GDP growth projection for the year went from 1.4% to 2.1%. This is also consistent with other economists' predictions as growth has surprised to the upside in the first quarter.

With financial markets and the Fed both discounting hotter-than-expected inflation data, coupled with better-than-expected economic data, stock markets have sprung higher. Optimism around artificial intelligence remains strong, and unemployment remains low. While this is good news, markets generally don't go straight up, and corrections are common. We would not be surprised to see a pullback at some point, but predicting the timing is difficult and not advised. A pullback could provide opportunities as well. There is a lot of money in money market funds and bank savings accounts, and some of these assets could be deployed if markets dip, providing some investors an opportunity to get back into the market.

Bond markets could also have some ups and downs as investors try to anticipate inflation data and the Fed. Currently, investor expectations match the Fed's expectations, but this can change quickly. If March inflation data comes in hot again, we could see bonds retreat as markets price in a higher-for-longer Fed funds rate. Conversely, if inflation data retreats in March, this could be good news for bond investors.

Your Cetera financial professional can keep you focused on your personal goals and objectives. There will be added distractions thanks to it being an election year, but focusing on your own goals and objectives will help take the emotion out of investing.

## Global Economy

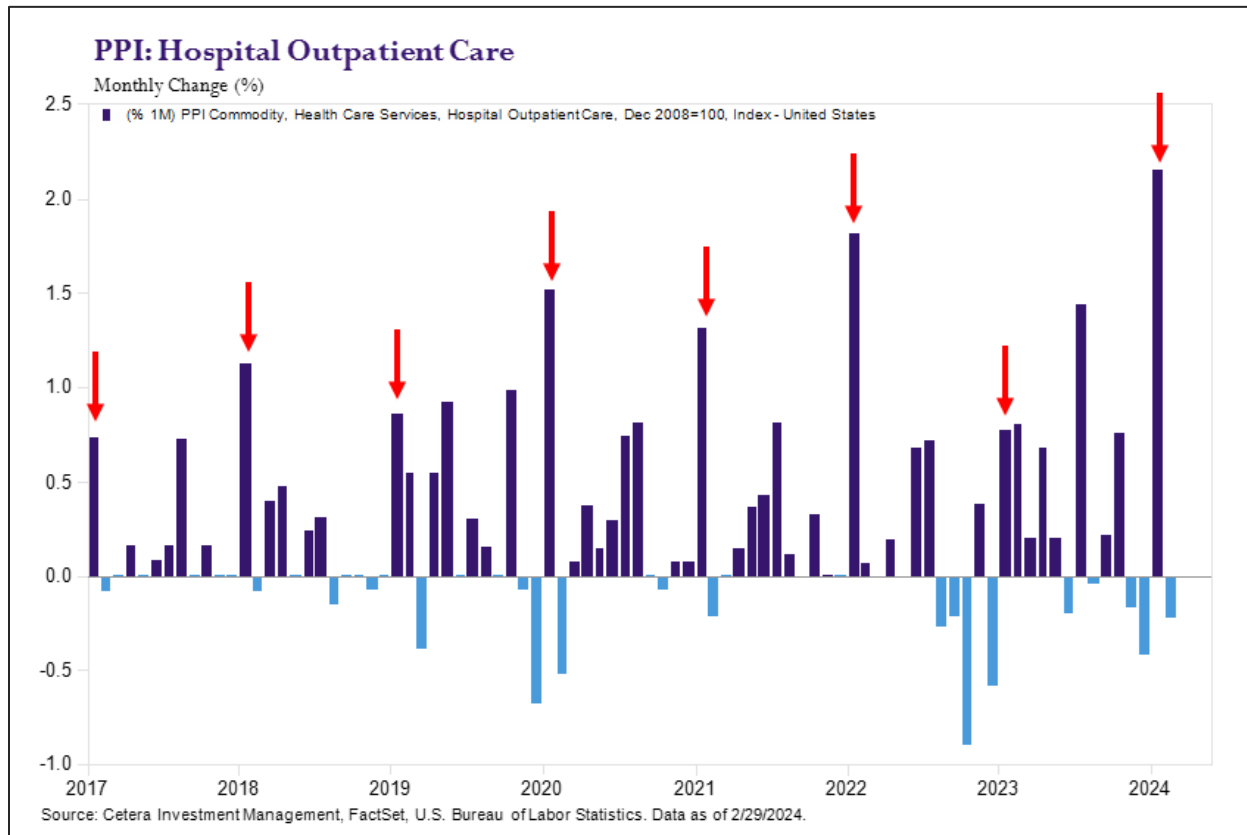
In looking at the economy, let's first start with the Fed's main concern now: inflation. Heading into the year, inflation seemed under control, but the Fed was reluctant to wave the victory flag. Annualizing inflation data from July to December, the inflation rate, as measured by the Fed's favorite inflation metric, the core Personal Consumption Expenditure Price Index (Core PCE Price Index) was running under the Fed's 2% target. The 12-month rate was still around 3%, but that was being dragged higher from the first six months of the year when inflation was running hotter.

January, however, provided some inflation surprises that somewhat justified the Fed's wait-and-see approach. For the month, inflation exceeded economist expectations and the six-month annualized inflation rate jumped to around 2.5% and above the Fed's target. However, since January 2023 inflation was higher, the 12-month inflation rate eased slightly. Regardless, January proved inflation may be more stubborn than investors had hoped. On top of that, the consumer price index (CPI) and the producer price index (PPI) indicated that inflationary pressures were elevated in February, as well.

We would caution putting too much weight into the January data, however. Economic data is very hard to adjust for seasonality as the U.S. economy is over \$20 trillion. A large part of inflation data is related to rental costs, which are largely estimated based on the amount a homeowner can rent their primary residence (owners' equivalent rent). It is a somewhat hypothetical inflation figure and in January this figure deviated substantially from inflation seen in actual rentals of primary residences. February saw owners' equivalent rents ease, but we didn't see as large of a reversal as expected. Regardless, with newly listed rental properties showing modest weakness, we expect rent inflation to eventually slow.

This was also not the only anomaly in January. Many companies increase prices for the new year as old contracts expire and new ones take effect in the month of January. While data is often seasonally adjusted to account for this seasonal anomaly, the January data may not fully account for these price hikes. To illustrate the January effect, we looked at the Producer Price Index for Hospital Outpatient Care and highlighted January's with red arrows (**Figure 1**). HMOs and hospital equipment makers raise prices in January, causing inflation for outpatient care to spike in the first month of the year. As shown in Figure 1, this metric declined in February.

Figure 1: January Hospital Outpatient Care



While we had some inflation surprises in the first part of the year, we still anticipate the Fed cutting rates, possibly as early as June. If we strip out shelter costs, such as owners' equivalent rent, the 12-month CPI is under 2% as of February (PCE for February doesn't get released until the end of March). Investors in the futures market have currently priced the probability of a June rate cut at just over 50%.

Investors are cheering for rate cuts, but they should also be careful what they wish for, as cuts could accelerate if there are signs of a severe economic slowdown. The good news is that this does not appear to be a near-term concern, so maybe higher-for-longer rates aren't that bad. The recent strength of the economy and labor market are providing the Fed the ability to be patient.

Heading into the year, economists thought if we saw a recession in 2024 it would likely be in the first half of the year. Economic data in the first quarter appears moderate though and no recession appears to be imminent. The Atlanta Fed looks to predict GDP growth in real time and is projecting growth to be over 2% in the first quarter, which is in line with economists' current estimates.

The labor market is showing signs of moderating, but at current levels there are no recessionary signs. The unemployment rate has been under 4% for 25 consecutive months through February, something that hasn't happened since the 1960s. If people have jobs and are making money, they should continue to spend that money. The U.S. is predominantly a consumer-driven economy, so this is important. The unemployment rate does tend to bottom out prior to a recession, but with current labor shortages in certain sectors of the economy, hopefully this is not the case and rising unemployment from low levels could just be a sign the economy is normalizing from the pandemic economy. Furthermore, the pace of jobs growth is still healthy.

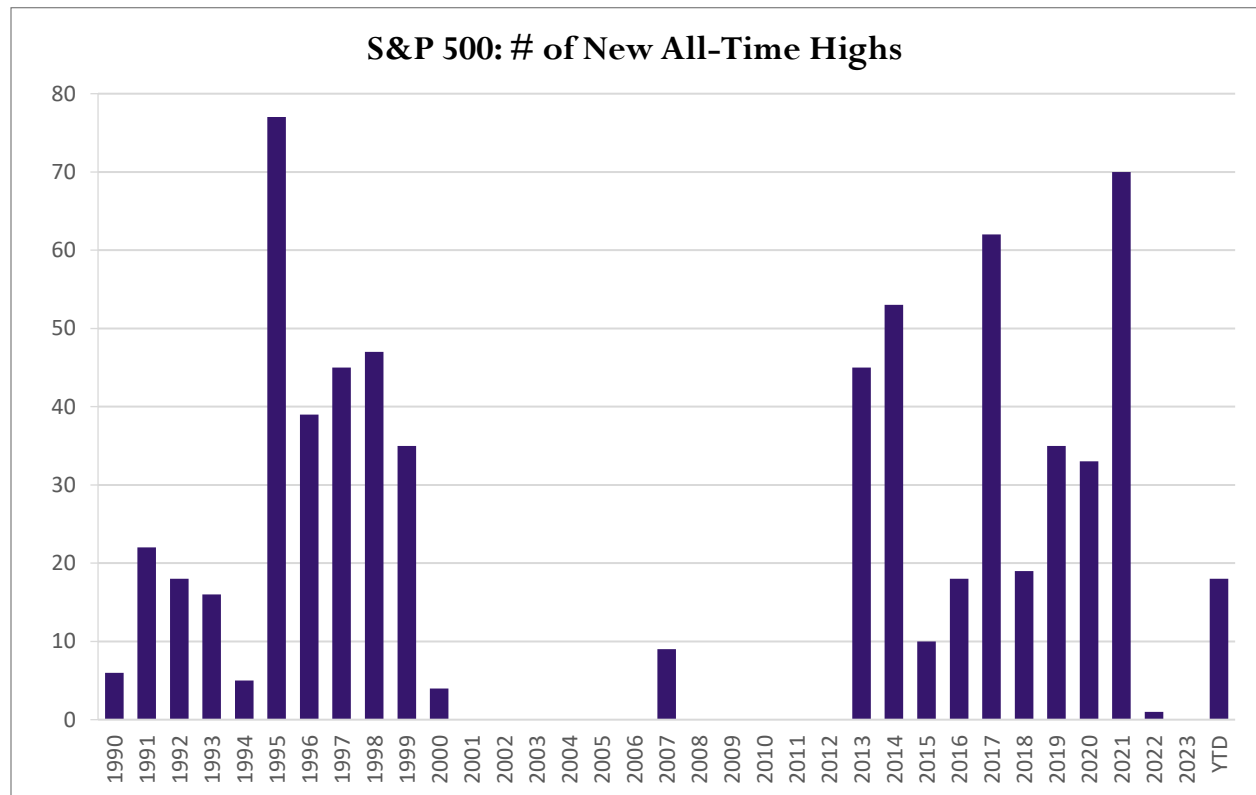
The economic landscape isn't as rosy outside of the United States. As of March 13, London based economic firm Capital Economics estimates 2024 U.S. GDP growth to be 2.5%, while the Eurozone, Japan and the U.K. growth rates are expected to be 0.1%, 0.4% and 0%, respectively. At these expected low levels of growth, a non-U.S. recession isn't far away from forecasts.

Emerging markets have higher growth rates, but slower growth could feel like negative growth for these countries. The Chinese economy is starting to show cracks in the real estate sector which was overbuilt. Growth is slowing and prices are falling. Consumer prices in China fell at their steepest pace in 14 years in January. This could cause disinflationary pressures for the rest of the world as China tries to sell its goods at cheaper prices. This would help developed economies with their inflation problems but could cause other problems. Weak economic growth could hurt foreign companies selling to Chinese consumers. We will continue to monitor China's economy as the year progresses.

### Equity Markets

Stocks have pushed higher in 2024, reaching 19 new all-time highs thus far (as of this writing). In 2023, there were no new all-time highs and 2022 only saw one, which was recorded the first trading day of the year. These sorts of records do tend to come in streaks though. Prior to the recent draught, the S&P 500 hit 70 all-time highs in 2021, for example (**Figure 2**).

**Figure 2: All-Time Highs by Year**



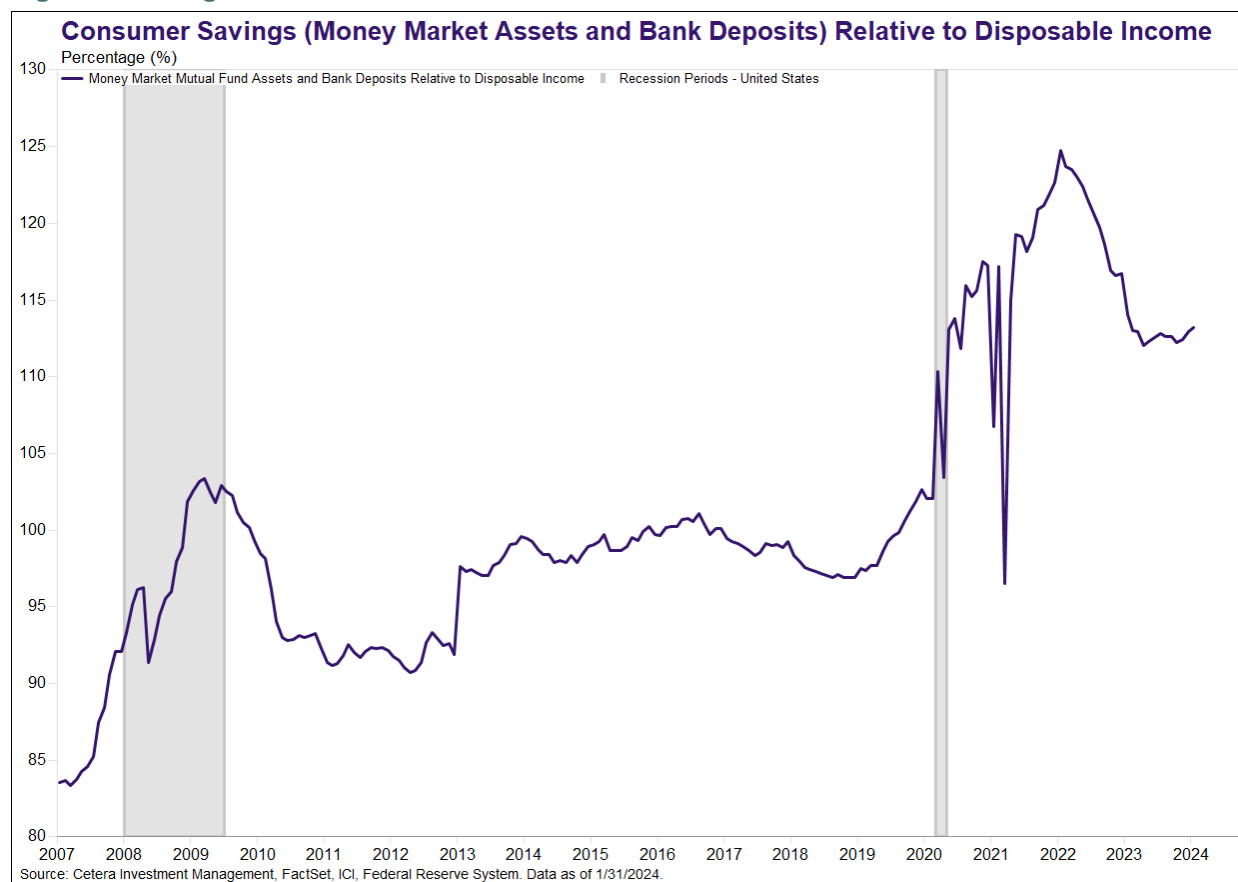
Source: Cetera Investment Management, FactSet, Yahoo Finance, Standard & Poor's. Data as of 3/20/2024.

While markets have moved higher, it has largely been a story about multiple expansion, meaning stock prices have gone higher while earnings have lagged. Earnings growth is expected to be better in the future though, which is driving the optimism. Stock markets are forward-looking, but if earnings don't match expectations, the risk of volatility increases. As such, valuations in large cap stocks are stretched relative to their long-term average. This is more pronounced for large cap growth and technology stocks, which are influenced by artificial intelligence enthusiasm, driving valuation levels to even more elevated levels.

With stock markets climbing without much pause, it would be expected that we could eventually see some pullbacks. Corrections, or 10% pullbacks in markets, are a normal part of investing. Predicting the timing is difficult, so waiting for this to occur isn't advisable either. Diversification is the key to mitigating stock market volatility—diversifying stocks and even owning bonds where appropriate.

The good news is that any potential pullback could provide opportunities to find good entry points into a long-term strategic investment plan. Americans have saved a lot collectively after refinancing their mortgages early in the pandemic and stockpiling stimulus money. We realize everyone's situation is different, but in aggregate, Americans' have a high level of savings. **Figure 3** shows the amount of savings relative to disposable income, indicating we are above pre-pandemic levels. It is important to show this figure relative to something like disposable income because over time savings will grow as the economy grows. We will always be close to all-time highs for savings as inflation grows and the economy and wages expand. The savings we are referring to is in money market and bank deposits. It is possible that if we do see stock market pullback, some savings could make their way into the stock market as investors seek better entry points. There is a lot of cash on the sidelines right now, possibly waiting to be deployed.

**Figure 3: Savings**



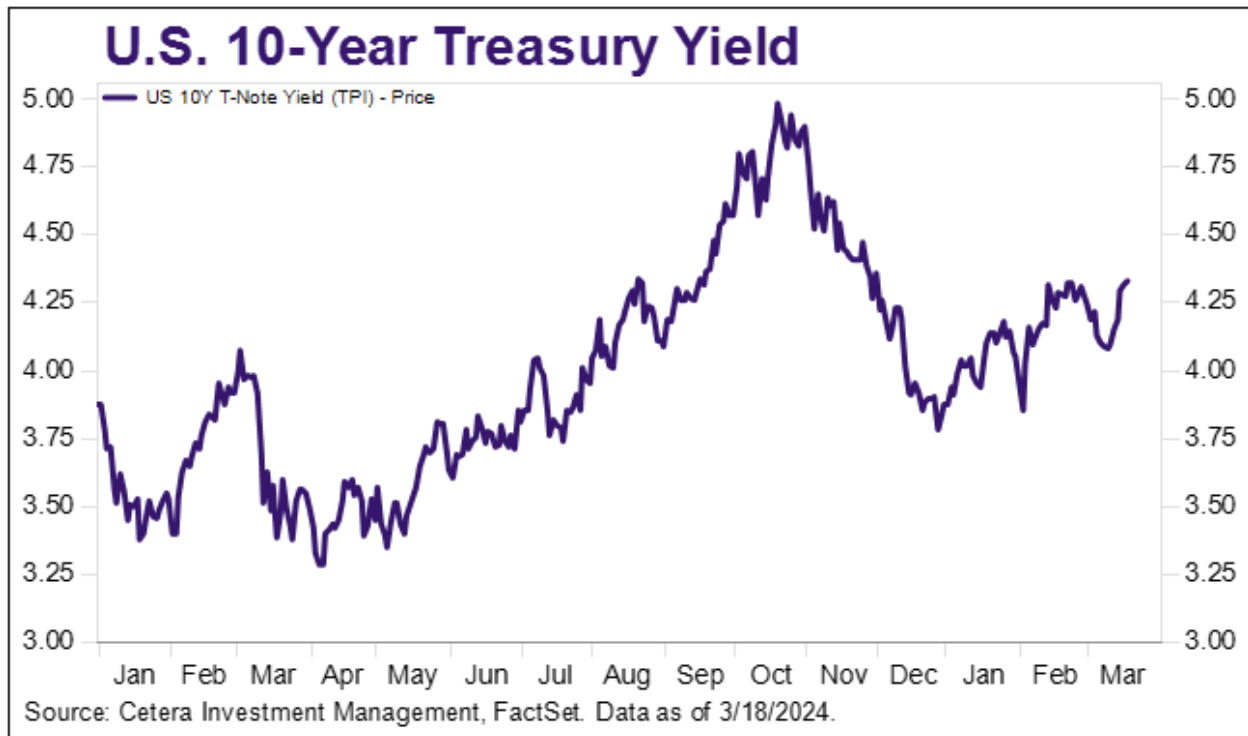
## Fixed Income

Volatility isn't confined to stocks either, as we saw last year in the bond market. This year bonds have had some steep movements up and down, but overall bonds are still mostly negative heading into the second quarter. Shorter-term bonds and high-yield bonds are the exception. High-yield bonds tend to correlate more strongly with equities. You can see the movement in the 10-year Treasury yield in Figure 4. Keep in mind bond yields move inversely to bond prices.

Long-term bond yields are influenced by future inflation and growth expectations. If inflation or economic growth is expected to be higher, bond yields will also likely go higher, pushing down bond prices. Predicting bond yields can be challenging, but if we go back to a pre-pandemic economy, one might expect bond yields to retreat eventually.

Shorter-term bonds are more correlated with Fed interest rate expectations. Currently, bond investors seem to be on the same page with the Fed but that can change quickly. When it does, bond yields adjust accordingly. A higher-for-longer Fed rates scenario could mean lower bond prices (and higher yields) while a dovish Fed that is cutting rates more than expected could mean higher bond returns (and lower yields). Again, predicting this is difficult and depends a lot on inflation data and other economic data, but you can see the potential for volatility in bond markets. However, volatility in bond markets is not the same as volatility in equity markets. Higher grade bonds with shorter maturities have less price movements than longer-term bonds and equities.

Figure 4: Bond Volatility



We mentioned high-yield bonds being correlated to equities and being a bright spot in the bond market. Currently, these bonds don't appear to be factoring in a recession or credit event. The spreads over Treasuries are tight, so if we did see economic weakness or stock market volatility, these bonds could fall. We are cautious within the high-yield market for these reasons.

### **The Bottom Line**

The Goldilocks scenario of a resilient economy coupled with the Fed getting ready to cut interest rates is becoming more likely. This scenario isn't set in stone, however. While everyone is discounting hotter-than-expected inflation readings, the risk of another hot reading brings more gravity. While the Fed can look past a few bad inflation reports, another one may signal a trend and not an anomaly. Additionally, there are risks in the Fed not cutting rates soon enough. Their current interest-rate policy is restrictive and could eventually cause a recession. The Fed's optimism around the economy and inflation is also shared by investors which have pushed up stock prices with earnings yet to catch up.

This could be setting the stage for some turbulence in markets as investors recalibrate their projections and expectations. Stock markets have largely gone up with little resistance to start the year, so we would expect some pullbacks along the way. We do think any pullbacks could be short-lived and investors would be wise not trying to time them. While there are risks in the market, a lot of the optimism is warranted. We do believe inflation will continue to ease, the Fed will cut rates and the economy will remain on solid footing.

Diversification is prudent and your Cetera financial professional can help you through any uncertainty and help keep you focused on your personal goals and objectives.

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